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SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1962

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I. Introduction

THE Self-Employed Individuals Tax Retirement Act of 1962 [hereinafter referred to as H.R. 10] was signed into law by President Kennedy on October 10, 1962.[1] The act permits approximately seven million self-employed individuals[2] to participate in retirement plans qualified under Section 401 of the Internal Revenue Code of 1954 and to secure some of the advantages previously granted only to regular or common-law employees under such plans.[3]

The enactment into law of H.R. 10 in 1962 climaxed nearly 20 years of effort[4] on the part of professional and other self-employed persons to secure for themselves tax-sheltered retirement benefits similar to those available for many years past to common-law employees.[5] The work of various committees toward this end had resulted in the introduction of legislation in the first session of the 82d Congress (1951) under the title "A bill to permit the postponement of income tax with respect to a portion of earned net income paid to a restricted retirement fund."[6] This initial legislation was not restricted to the self-employed: it was designed to help also the great number of people who are common-law employees but who are not covered by retirement plans, and to permit common-law

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1. 76 Stat. 809 (1962) (Codified in scattered sections of 26 U.S.C.). The act is effective for taxable years beginning after December 31, 1962. A plan adopted by December 31, 1963 may be made retroactive to January 1, 1963.

2. Other estimates of potential coverage have varied a few million either way.

3. "The Koegh bill [H.R. 10] recognizes that a person in business for himself, a self-employed doctor, dentist, or lawyer, or the corner druggist has the right to the same tax exemption for retirement purposes now enjoyed by his cousin who works for General Motors either as a top-rung executive or factory assembler." Hearings on H.R. 10 Before the House Committee on Ways and Means, 84th Cong., 1st Sess. 122 (1955) (remarks of Representative Reuss).

4. See Rapp, The Quest for Tax Equality for Private Pension Plans: A Short History of the Jenkins-Keogh Bill, 14 Tax L. Rev. 55, 57 (1958).

5. The first legislation offering tax relief to the retirement dollars of common-law employees was contained in the Revenue Act of 1921, ch. 136, § 219(f), 42 Stat. 227. The initial provision was limited to profit-sharing and stock bonus plans, but the Revenue Act of 1926 extended coverage to pension plans. Between 1921 and 1962, the expansion by successive Congresses of the tax benefits to qualified pension, profit-sharing and stock bonus plans for common-law employees resulted in phenomenal growth of such plans. U.S. Treas. Dep't, Int. Rev. Serv., Statistics, Release of Feb. 21, 1963, estimate a total of 81,852 "qualified" plans (pension, profit-sharing and stock bonus).

6. H.R. 4371, H.R. 4373, 82d Cong., 1st Sess. (1951).

employees who are participants in employer-established retirement plans to set aside additional money of their own up to the maximum deduction permitted by the bill.[7]

For the next eleven years the proposed legislation had an interesting and stormy history. Again and again its provisions were amended. Among the amendments was one which restricted coverage under the bill to self-employed persons.[8] Reactions to the final version which became law in 1962 were mixed. Not even its most ardent supporters claimed a great victory. They contented themselves with acclaiming the law as an opening wedge. Other comments ranged from the "opening-wedge" variety down to a description of the act as "a complex, confusing, unwieldly, and unworkable legislative dud."[9]

Proposed regulations were issued in April[10] and in June[11] of 1963. On September 17, 1963, these regulations were published in final form in the Federal Register.[12] Promulgation of the major portion of the regulations and of procedural guides[13] enable prospective beneficiaries of the act at last to make a prudent judgment as to whether it is to their interest to establish a retirement plan within the scope of H.R. 10. It is the purpose of this paper to show wherein the act helped, or failed to help, the self-employed to secure benefits comparable to those obtainable by common-law employees and to give a broad view of some of the major considerations facing the self-employed person as he makes his decision. With this end in view, the treatment is not intended to be exhaustive or unduly technical, but synoptic.

II. Requirements of a Qualified Plan

The final H.R. 10 legislation took the form of amendments to Sections 401-04 of the Internal Revenue Code,[14] the addition of a new section 405, and amendments to certain other related sections of the Code.[15] Sections 401-04 govern qualified retirement plans established for common-law em-

7. The maximum deduction permitted in the 1951 bill was 10% of earned income or $7,500.

8. This amendment was incorporated in H.R. 9 and H.R. 10, 85th Cong., 1st Sess. (1957).

9. MacNeill, What Price H.R. 10 Today?, 102 Trusts & Estates 9 (1963).

10. Proposed Treas. Regs. §§ 1.401, 1.401-1, -3, -4, -6 to -13, 1.405, 1.405-1 to -3, 28 Fed. Reg. 3401 (1963).

11. Proposed Treas. Regs. §§ 1.72, 1.72-1, -6, -11, -15 to -18, 1.401-13, 1.402(a)-1, 1.403(a), 1.403(a)-1, -2, 1.404(a), 1.404(a)-1, -8, 1.404(e), 1.404(e)-1, 1.404(f), 28 Fed. Reg. 6215 (1963).

12. Treas. Regs. §§ 1.401, 1.401-1, -3, -4, -6 to -13, 1.405, 1.405-1 to -3 (1963).

13. Rev. Proc. 63-23, 1963 Int. Rev. Bull. No. 41, at 84.

14. Int. Rev. Code of 1954.

15. Int. Rev. Code of 1954, §§ 37, 62, 72, 101, 104, 105, 172, 503, 805, 1361, 2039, 2517, 3306, 3401, 6047, 7207.

ployees by corporations, partnerships and sole proprietors. Thus the provisions of H.R. 10 are superimposed upon the law applicable to such plans[16] and such law applies to H.R. 10 plans in every respect unless it is directly overruled by a contrary provision of H.R. 10. To understand H.R. 10, therefore, and to appreciate what the self-employed proponents of the bill hoped for, and what they received, it is necessary to be familiar with the law applicable to qualified retirement plans for common-law employees. A brief review of this law can be obtained by focusing on a typical situation in the field *as it existed before H.R. 10*. If the XYZ partnership wished to establish a plan providing retirement benefits for its employees and to qualify the plan under Section 401 of the Internal Revenue Code in order to obtain the tax advantages of a qualified plan, it was met at once with the hard fact that section 401 requires that such a plan be for the exclusive benefit of "employees or their beneficiaries."[17] Before H.R. 10, partners could not qualify as employees,[18] which meant that only the regular or common-law employees—the ones whose wages were withheld on and whose work was subject to direction and control—could participate in the plan. The partners, no matter how small or how large their percentage interest in the partnership, were not eligible to participate.

The plan, to be qualified for tax advantages, had to comply with all the requirements of section 401.[19] For example, section 401 requires a definite written program embodying a plan intended to be permanent and setting forth all provisions essential for qualification.[20] If there is a trust, it must be impossible under the trust instrument for any of the trust corpus or income to be used at any time other than for the exclusive benefit of the employees or their beneficiaries.[21] The trust must be valid and existing under controlling local law and must be created or organized within the United States.[22]

The plan must cover a specified minimum percentage of all employees

16. "The problem is complicated by the use of Section 401 as the statute around which to draft amendments to permit tax deferment for self-employed retirement plans. I am sure that if a statute were to be drawn solely for professional and self-employed persons, the needs of this group would be paramount and would be recognized. But this was not done, so that the general practitioner down the street is treated in the same manner as the General Motors Corporation." Bliss, Eliminating H.R. 10 Road Blocks—Bank's Role Under Self-Employed Retirement Plans, 102 Trust & Estates 96 (1963).

17. Int. Rev. Code of 1954, § 401(a).

18. I.T. 3350, 1940-1 Cum. Bull. 64.

19. See Alexander, Rules Governing Qualification of Pension and Profit-Sharing Plans, 21 Institute on Fed. Taxation 661 (1963).

20. Treas. Reg. § 1.401-1(a)(2) (1960).

21. Int. Rev. Code of 1954, § 401(a)(2).

22. Int. Rev. Code of 1954, § 401(a).

or, in the alternative, a special classification of employees acceptable to the Commissioner.[23] Contributions or benefits must not discriminate in favor of officers, stockholders, highly-paid or supervisory personnel.[24] The plan may limit coverage to employees earning more than some stated amount or it may apply a higher contribution or benefit rate to compensation above a stated figure, but if it does it must integrate with social security according to rules set down by the Commissioner of Internal Revenue.[25] The integration rules are satisfied if the sum of the social security benefits and plan benefits for the highly-compensated and favored classes of employees is no greater percentage of their compensation than the percentage of compensation represented by the sum of the social security benefits and plan benefits (if any) for the lower-paid employees.

The XYZ partnership could set up either a pension or profit-sharing plan. A pension plan is designed primarily to provide "systematically for the payment of definitely determinable benefits to . . . employees over a period of years, usually for life, after retirement."[26] Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent on profits. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purpose of section 401(a), be considered a pension plan if the employer's contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of incidental death benefits[27] through insurance or otherwise. A pension plan may not provide for the payment of benefits not customarily included in a pension plan, such as layoff benefits or benefits for sickness, accident, hospitalization or medical expenses.

23. Int. Rev. Code of 1954, § 401(a)(3).

24. Int. Rev. Code of 1954, § 401(a)(4). See Treas. Reg. § 1.401-4(a)(2)(i) (1963), which specifically provides that a plan "will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation or to the basic or regular rate of compensation, or merely because the contributions or benefits based on that part of the annual compensation of employees which is subject to the Federal Insurance Contributions Act [chapter 21 of the Code] differ from the contributions or benefits based on any excess of such annual compensation over such part."

25. Int. Rev. Code of 1954, § 401(a)(5); Treas. Reg. § 1.401-3(e).

26. Treas. Reg. § 1.401-1(b)(i) (1956).

27. In the case of a pension or annuity plan, the life insurance benefit is deemed to be incidental where the insurance protection is not greater than 100 times the monthly annuity, e.g., $1,000 of life insurance for each $10 of monthly annuity. Rev. Rul. 60-83, 1960-1 Cum. Bull. 158.

A profit-sharing plan is designed to provide for participation by employees and their beneficiaries in the current or accumulated profits of the employer.[28] A profit-sharing plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death or severance of employment. A formula for allocating the contributions among the participants is considered to be definite if it provides for an allocation in proportion to the basic compensation of each participant. The regulations state that a profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance.[29]

The normal retirement age in a pension plan is usually 65, the same as under the old-age, survivors and disability insurance provisions of the Social Security Act. Since benefits in a profit-sharing plan are dependent upon profits, a stated retirement age is merely one of several acceptable occurrences giving rise to distribution, and "retirement" earlier than 65 has no particular significance.[30]

Neither a pension nor a profit-sharing plan need vest—*i.e.*, make nonforfeitable—benefits in the employees until retirement, but care must be taken, in plans which unduly delay the giving of vested rights, that forfeitures resulting from delayed vesting do not lead to discrimination in operation of the plan in favor of officers, stockholders, supervisory or highly-compensated personnel who would most likely remain with the employer until retirement.[31]

When the partnership had drafted a plan that both met the requirements of the Internal Revenue Code and satisfied the needs and goals of the partnership in establishing the plan, the firm applied to the local Dis-

28. Treas. Reg. § 1.401-1(b)(1)(ii) (1956).

29. In the case of a profit-sharing plan which provides for the use of trust funds to purchase and pay premiums on ordinary life insurance contracts, the insurance feature is deemed to be incidental if: (1) the aggregate premiums for life insurance in the case of each participant is less than one half of the aggregate of the contributions allocated to him at any particular time; and (2) the plan requires the trustee to convert the entire value of the life insurance contract at or before retirement into cash, or to provide periodic income so that no portion of such value may be used to continue life insurance protection beyond retirement, or to distribute the contract to the participant. Rev. Rul. 54-51, 1954-1 Cum. Bull. 147, as amplified by Rev. Rul. 57-213, 1957-1 Cum. Bull. 157, and Rev. Rul. 60-84, 1960-1 Cum. Bull. 159.

30. Rev. Rul. 61-157, pt. 5, ¶ h, 1961-2 Cum. Bull. 67.

31. Rev. Rul. 61-157, pt. 5, ¶ c, 1961-2 Cum. Bull. 67.

trict Director's office for a "Determination Letter"[32] that the plan (and trust, if there was one) met the applicable sections of the Internal Revenue Code, and in due course received a favorable determination letter which stated in part that "the law is concerned not only with the form of a plan but also with its effects in operation."

III. Advantages of a Qualified Plan

What were the effects of qualification? The partnership obtained a current deduction for amounts contributed to the plan on behalf of the common-law employees.[33] The employees had no taxable income until the moneys were eventually distributed or made available to them.[34] Meanwhile, contributions were put into a trust fund and invested for their benefit. The only expense to the fund was the trustee's fees and charges. Interest, dividends and capital gains on sales of securities accumulated tax free.[35] Any distribution made to an employee while he was still in service was taxable to him at ordinary income tax rates.[36] A distribution upon termination of employment in the form of an annuity or in installments was also taxable at ordinary income tax rates. But a lump-sum distribution was taxable at capital gain rates if it was paid within one taxable year of the distributee on account of the employee's death or other separation from service, or on account of the death of the employee after his separation from service.[37]

If payment was made to a beneficiary because of the employee's death, the amount attributable to the employer's contribution was excluded from estate tax if it was paid to any beneficiary except the executor of the employee's estate.[38] Under certain conditions the beneficiary was entitled to exclude up to $5,000 of the distribution from income tax.[39] If the employee retired for disability, up to $100 a week of his disability pension could be excluded from taxable income.[40]

These are substantial advantages. It is small wonder that the self-employed coveted them. In the words of Congressman Keogh, "The primary

32. Rev. Rul. 61-157, pt. 4, ¶ i, 1961-2 Cum. Bull. 67.

33. Int. Rev. Code of 1954, § 404.

34. Int. Rev. Code of 1954, § 402(a)(1).

35. Int. Rev. Code of 1954, § 501(a). Similarly, §§ 805(d)(1)-(2) of the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112 (codified in scattered sections of 26 U.S.C.), granted exemption, fully effective in 1961, to income on insurance reserves established in connection with qualified pension plans.

36. Int. Rev. Code of 1954, § 402(a)(1).

37. Int. Rev. Code of 1954, § 402(a)(2).

38. Int. Rev. Code of 1954, § 2039(c).

39. Int. Rev. Code of 1954, § 101(b).

40. Int. Rev. Code of 1954, § 105(d); see Treas. Regs. §§ 1.105-4(a)(3)(i), 1.402(a)-1(a)(1)(ii) (1956).

reason for the bill [H.R. 10] is to give self-employed persons access to retirement plans on a reasonably similar basis to that accorded corporate stockholder employees."[41]

How well did H.R. 10 accomplish this primary purpose?

IV. H.R. 10—The Final Version

The final version of H.R. 10 watered down the advantages to all self-employed people and severely restricted the rights of sole proprietors and partners who own more than a ten per cent interest in their partnership. This latter class the act refers to as "owner-employees."[42] In studying H.R. 10, it is absolutely imperative to keep in mind at all times that H.R. 10 divides self-employed people into two categories: (1) sole proprietors and individuals who own more than ten per cent of either the capital interest or the profits interest in a partnership; and (2) partners who own ten per cent or less of the capital interest or the profits interest. The act designates the first class "owner-employees." We shall designate the second class "junior partners."

Who are the self employed for the purposes of H.R. 10? They are individuals who have "earned income" as defined in the act.[43] Earned income in general means net earnings from self-employment to the extent such net earnings constitute compensation for personal services actually rendered. An individual may have net earnings from self-employment for purposes of H.R. 10 even though he doesn't have self-employment income for purposes of social security coverage. H.R. 10 extends its benefits to doctors, ministers, Christian Science practitioners, commission-drivers, traveling salesmen and homeworkers. An individual who renders no personal services has no earned income even though he may have net earnings from self-employment from a trade or business. For example, a partner in a brokerage house whose income is from capital only cannot participate in an H.R. 10 plan because he renders no personal services and therefore has no "earned income" within the meaning of H.R. 10.[44]

Professional fees constitute earned income. So do the guaranteed payments of a partner, as well as his distributive share of partnership income (whether or not distributed). What constitutes the earned income of a grocer or a gasoline station operator? In a trade or business where both capital and personal services are material income-producing factors, the act makes an arbitrary assumption that only thirty per cent of net profits is attributable to personal services.[45] Thus the "earned income" of indi-

41. H.R. Rep. No. 378, 87th Cong., 1st Sess. 2 (1961).
42. Int. Rev. Code of 1954, § 401(c)(3).
43. Int. Rev. Code of 1954, § 401(c)(2).
44. Int. Rev. Code of 1954, § 401(c)(2); see Treas. Reg. § 1.401-10(c)(3) (1963).
45. Int. Rev. Code of 1954, § 401(c)(2).

viduals in such businesses can't be more than thirty per cent of the net profits from the business (but not less than the first $2,500 of net profits if the individual renders full-time personal service).[46]

The amount of earned income determines the amount a self-employed person can contribute or deduct. The contribution on behalf of an owner-employee is limited to ten per cent of earned income from the trade or business with respect to which the plan is established *for the year of the contribution*, or $2,500, whichever is less.[47] The credit and contribution carry-overs available with respect to contributions for common-law employees are not available to contributions for self-employed individuals. Of course, the contribution for the owner-employee must not be discriminatory as compared to contributions for his employees.

The doctor or the lawyer with a net income of $25,000 in 1963 may contribute $2,500. But the grocer with net profits of $25,000 can contribute only $750! ($25,000 × 30% × 10%.) So it is easy to see that the professional man gets a much better break than the businessman. Surely if a businessman can prove that three quarters of his profits derive from personal service, he should not be penalized by the law's arbitrary thirty per cent assumption.

The contribution for each year must be made before the close of the taxable year. This requirement will undoubtedly cause practical problems to self-employed individuals with incomes which fluctuate widely from year to year.

46. The following illustrations indicate the determination of earned income in various situations: 1. A doctor has net profit of $40,000 from professional services. His patients look to him as the person responsible for the services rendered. The full amount of this net profit constitutes earned income; 2. A self-employed grocer has net profit of $40,000 from his wholly owned retail grocery business. Both capital and personal services are material income-producing factors. His earned income is $12,000 (30% of $40,000); 3. A gasoline service station operator has net profit from his wholly owned unincorporated service station of $2,400. Both capital and personal services are material income-producing factors. Under the bill, the entire amount of such net profit is deemed to be earned income since it does not exceed $2,500; 4. A contracting partnership composed of three partners who share equally in its profits has partnership net profit of $22,500. Both capital and personal services are material income-producing factors. Of the $7,500 attributable to each partner, $2,500 constitutes earned income (30% of $7,500, or $2,500, whichever is greater, where each partner's share of net profits exceeds $2,500); 5. A and B are partners in a stock brokerage firm. A supplies all necessary capital but performs no personal services. B has no capital interest, but performs all personal services required by the firm. They share profits equally. Both capital and personal services are material income-producing factors. The firm has net profits from brokerage commissions of $50,000 and total net profit from all sources of $70,000. A has no earned income from the partnership since he performed no personal services. B has earned income of $10,500 (30% of $35,000).

47. Int. Rev. Code of 1954, §§ 401(d)(11), 404(a)(9)(B), 404(e)(1).

The deduction available to an owner-employee is one half the contribution actually made, with a maximum deduction of $1,250. Thus, in the case of the grocer who could contribute only $750, the deduction is limited to $375.

V. A Case History

To put H.R. 10 into perspective, let's look at a typical H.R. 10 situation. The firm of Book & Case is engaged in the practice of law. Mr. Book has a sixty per cent interest in the partnership. Mr. Case has a thirty per cent interest. Mr. Junior has a ten per cent interest. Messrs. Book and Case therefore are owner-employees and Mr. Junior is merely a junior partner, a self-employed person under H.R. 10 but not an owner-employee. The firm has three associates, two of whom have been employed for five years and one who has been employed for two years. There are two stenographers, each employed more than three years, and a typist who has been with the firm two years. A part-time bookkeeper comes in twice a month. Occasionally when the workload is unusually heavy, the firm gets extra typists from a company which supplies such help on a temporary basis.

Messrs. Book and Case look with interest at H.R. 10 since they would like to set aside some tax-deductible retirement income against the day when their earning power may wane. The first thing they must do is recognize their special status as owner-employees and apply to themselves and to their plan all the provisions applicable to owner-employees. The act provides that a plan won't cover an owner-employee unless the owner-employee consents to being included under the plan.[48] Consent need not be affirmative. It is implied if a contribution is made by the employer to the plan on behalf of an owner-employee.[49] Since Book and Case are interested in what H.R. 10 can do for them, they intend to consent to participation. They then discover that any plan benefiting an owner-employee must benefit each full-time employee having a period of employment of three years or more.[50] That means the plan must immediately cover the junior partner, two of the associates and the two stenographers. If the other associate and the typist complete three years of employment, they too must be covered at such time, and all future employees who complete three years of employment must then also be covered. It has been facetiously (?) suggested that there may be increased turnover among employees approaching the three-year mark. The book-

48. Int. Rev. Code of 1954, § 401(d)(4)(A).

49. Treas. Reg. § 1.401-12(b)(1) (1963).

50. Int. Rev. Code of 1954, § 401(d)(3).

keeper need not be covered because he is a part-time employee. The typists who are supplied by the service company are not to be covered because they are the employees of the service company and not of Book & Case. It has also been suggested that H.R. 10 may lead to the proliferation of service companies which supply stenographers, typists, receptionists, clerks, messengers and similar help. Increased reliance on the services of such companies seems to present no problem, but the incorporation of separate service companies by owner-employees of a business would undoubtedly be questioned by the Commissioner as a transaction under the prohibition of section 269 of the Code which frowns upon the acquisition of a corporation with the purpose of evading or avoiding federal income tax.

The benefits provided for the employees must be nonforfeitable.[51] This gives Messrs. Book and Case pause: Are they subsidizing their associates toward the start of their own practice? No; non-forfeitability doesn't include the right of employees to take their share with them if they leave the employ of the firm. Distribution may be delayed by the terms of the plan until some later date or until sixty-five years of age. The requirement that all employees with three or more years of service be given non-forfeitable benefits is a special H.R. 10 restriction on owner-employees. If a partnership with no owner-employees (which we shall designate here as a junior partnership) were to set up an H.R. 10 plan, regular qualified plan law would apply in most respects. Employees with less than five years of service could be excluded from coverage[52] and vesting could be graduated over a period of years (as, ten per cent vesting each year of participation) or postponed until retirement. Vested benefits could be subject to forfeiture for certain causes, such as dishonesty, moral turpitude or entering competitive employment. But the employees of Book & Case cannot be required to forfeit benefits for any cause whatever. Nor can they be required to make contributions to the plan as a condition of participation, though a junior partnership might impose such a condition.

Messrs. Book and Case can establish either a pension or profit-sharing plan, but adoption of a pension plan might commit them to make contributions on behalf of their common-law employees even in loss years when they can make no contribution on their own behalf. By adoption of a profit-sharing plan, they can limit their liability to make contributions to years when they have a profit, and in this way they can make a contribution for themselves every time they make one for employees.

Since Book and Case are attorneys, they may face a roadblock to

51. Int. Rev. Code of 1954, § 401(d)(2)(A).
52. Int. Rev. Code of 1954, § 401(a)(3).

setting up a profit-sharing plan. The proposed regulations under section 401 of the Code provided that if state law proscribes fee-splitting between attorneys and non-attorneys and if the law treats the sharing of profits under a profit-sharing plan as such fee-splitting, then a qualified profit-sharing plan cannot be established if it is *possible* that an employee who is not an attorney may be covered under such plan. It is interesting to note that this provision does not appear in the final regulations. Nonetheless a law firm must still reckon with Opinion 303 of the Ethics Committee of the American Bar Association, which appears to proscribe a profit-sharing plan covering employees other than attorneys.[53]

If they establish a profit-sharing plan, it must contain a definite contribution formula—with respect to employees other than the owner-employees.[54] It would be impossible to have a definite contribution formula for the owner-employees in view of the limitations on their contributions and deductions. A definite contribution formula is no longer required in profit-sharing plans under regular qualified plan law, but its purpose in H.R. 10 apparently is to prevent the abuse of making larger and smaller contributions in years when surtax rates are lower or higher.[55] A junior partnership plan is not required to have a definite contribution formula.

Suppose an owner-employee has net earned income this year of $25,000 and would like to contribute the permitted maximum of ten per cent. Shall he provide for a contribution of ten per cent of compensation for his employees? If next year his earned income is $30,000, his contribution must be limited to the maximum permitted, *i.e.*, $2,500, which is less than ten per cent of his income. Can he correspondingly reduce the contribution on behalf of the employees and still have a definite contribution formula? There was much discussion of this problem when the law was first passed, but regulations fortunately resolved the question by providing that the requirement that the plan formula be definite is satisfied if such formula limits the amount to be contributed on behalf of all employees covered under the plan to the amount which permits self-employed individuals to obtain the maximum deduction permitted to them.[56]

Whether the plan established is a pension or profit-sharing plan, it must not discriminate in favor of the self-employed participants. The regulations state the reason clearly: "A self-employed individual, by reason of the contingent nature of his compensation, is considered to be a highly-

53. 48 A.B.A.J. 159 (1962).

54. Int. Rev. Code of 1954, § 401(d)(2)(B).

55. S. Rep. No. 992, 87th Cong., 1st Sess. 19 (1961).

56. Treas. Reg. § 1.401-12(d)(1) (1963).

compensated employee, and thus is a member of the group in whose favor discrimination is prohibited."[57]

Messrs. Book and Case decided to pursue further the possibilities inherent in H.R. 10. Since they are owner-employees, the partnership contribution on their behalf[58] is limited to the lesser of $2,500 or ten per cent of earned income each year. They consider it unjust that a contribution on behalf of partners with ten per cent or less interest in a partnership is not so limited, but the law is clear. They find, however, that there is a way to increase their contribution. H.R. 10 permits owner-employees to make additional contributions on a voluntary basis up to ten per cent of their earned income (or $2,500, whichever is less) *if* there are other employees and if those employees also are permitted to make voluntary contributions up to ten per cent of their compensation.[59] It is not necessary that the other employees take advantage of this provision; it is enough that they may if they so desire. Neither the self-employed nor common-law employees obtain any deduction for voluntary contributions, but the tax-free build up within a tax-sheltered retirement fund is often sufficient inducement. Voluntary contributions offer the possibility of one further advantage to the employer. By helping to build up a satisfactory retirement fund, the employer's contribution may be smaller than would otherwise be required to produce a satisfactory result.

How else might the cost of a plan to the employer be reduced? Messrs. Book and Case consider integrating the plan with social security. They know that under regular qualified plan law, a plan can take into account the social security *benefits* employees will eventually receive. They find that this rule still holds for a plan established by a junior partnership, but that if an owner-employee is covered, an entirely different integration concept applies which takes into account not the social security *benefits*, but the social security *taxes* paid by the owner-employee for other employees (including junior partners, if any). This different concept may be expressed as follows: If the allowable contributions for the owner-employee are not more than one third of the total contribution made to the plan and if he takes into account in that figure the social security taxes he paid for himself (or would have paid in the case of a doctor or other employer

57. Treas. Reg. § 1.401-11(d) (1963). The regulations add: "In determining whether the prohibited discrimination exists, the total employer contribution on behalf of a self-employed individual shall be taken into account regardless of the fact that only a portion of such contribution is allowed as a deduction." Ibid.

58. The partnership is the employer of each partner. Int. Rev. Code of 1954, § 401(c)(4). See also Treas. Reg. § 1.401-10(e)(1) (1963), which states: "An individual partner is not an employer who may establish a qualified plan with respect to his services to the partnership."

59. Int. Rev. Code of 1954, § 1.401(e)(1)(B).

not covered by social security), then he can take into account the social security taxes he actually paid for his employees.[60]

Would the employees perhaps consent to a cut in salary in exchange for participation in a qualified plan in view of the tax benefits? The act is silent but the regulations state that "self-employed individuals will not be considered as providing contributions or benefits for an employee to the extent that the wages or salary of the employee covered under the plan are reduced at or about the time the plan is adopted."[61] The regulations do not deal with the possibility that salary raises, otherwise expected, might be omitted or that current cash bonuses might be reduced.

Messrs. Book and Case stand back to look at the picture thus far presented. They may at last participate in a qualified plan which will permit them to contribute each year the lesser of $2,500 or ten per cent of their earned income for such year from their law partnership, and they may deduct one half of the actual contribution from their taxable income. They may, since they have other employees, make an additional contribu-

60. The following explanatory table appeared in S. Rep. No. 992, 87th Cong., 1st Sess. 16 (1961):

	Net profits or wages		Contribution		
	Per person	Total	10 per cent of wages of employees and 10 per cent of earned income of owner-employees	Credited self-employment tax and FICA tax paid by employer[1]	Net contribution under integrated plan
2 partners	$25,000[2]	$50,000[2]	$1,500	$451.20	$1,048.80
3 employees	6,000	18,000	1,800	450.00	1,350.00
1 employee	6,800	6,800	680	150.00	530.00
1 employee	3,170	3,170	317	99.06	217.94
Total, partners		50,000[2]	1,500	451.20	1,048.80
Total, employees		27,970	2,797	699.06	2,097.94
Total, partners and employees		77,970	4,297	1,150.26	3,146.74

[1] Self-employment tax, 4.7 per cent of employer's self-employment earnings up to $4,800; FICA tax, 3⅛ per cent of employee earnings up to $4,800.

[2] Earned income would be 30 per cent of this amount.

[The preceding table does not show changes in FICA and self-employment tax rates, effective 1-1-63.]

Treas. Reg. § 1.401-12(h)(4) (1963) states that such an integrated plan "may provide that such plan will be integrated with the Social Security Act only for such taxable years of the employer in which the requirements for integration are satisfied."

61. Treas. Reg. § 1.401-11(b)(2) (1963).

tion on a voluntary basis up to the same amount but no part of this further contribution will be tax deductible. They must make nondiscriminatory contributions for all full-time employees with three or more years of service and may deduct from partnership income the full amount of such contributions for common-law employees within limitations established by law. Contributions for their junior partner are not limited to ten per cent of earned income or $2,500, but the deduction therefor is limited to one half the actual contribution or $1,250, whichever is less. The benefits for the junior partner and common-law employees must be nonforfeitable. The plan formula may be integrated with social security.[62]

It is clear that Messrs. Book and Case must look to their economic situation and their future prospects before they commit the firm to a plan. Many are the doctors, the lawyers and the unincorporated candlestick makers who will look hopefully at H.R. 10 and abandon it regretfully when they see that tax-deductible, tax-sheltered retirement benefits for themselves can be purchased only at the cost, often prohibitive, of providing benefits for employees with three years of service.

Let us assume that Messrs. Book and Case are not discouraged. They work out some mathematical computations and obtain a fair idea of at least the present cost of a plan. Before working out details of the plan, and even before troubling to decide how the plan shall be administered, and its funds invested, they must review the advantages and disadvantages to themselves in further detail. It is true that they will get a tax deduction, up to a maximum of $1,250, of half their actual contribution, and their entire contribution can grow over the years in a tax-sheltered retirement fund, whereas if they invested the money outside the protection of such an umbrella, they would be taxable annually on interest and dividends as they accrued. However, moneys invested in securities outside of an H.R. 10 plan can bring capital gain on their sale. But H.R. 10 has been called the bill to convert capital gains into ordinary income. And so it does. While the trust can buy and sell securities over the term of the plan without tax incidence, the self-employed person upon distribution to him of his retirement fund, which may well include such securities, is denied the right to be taxed at capital gain rates, although this right is available to common-law employees who receive a total distribution upon separation from the service of the employer. Accordingly, a self-employed person might be well advised to invest his trusteed H.R. 10 funds in high-yield preferred stocks which would not increase in value while the dividends would accumulate tax free, and devote his other investment funds to common stocks.

62. We are assuming that Messrs. Book and Case do not engage in any other business. See Int. Rev. Code of 1954, § 401(d)(9) which contains stringent provisions with respect to owner-employees who control other businesses.

Furthermore, the owner-employee is putting the money he contributes beyond his reach until age fifty-nine and a half.[63] He cannot arrange to borrow it in case of emergency or unexpected financial setbacks,[64] although loan arrangements may be made available in such situations for common-law employees. If he sets age sixty-five as the first date his employees may draw down their money, he too will have to wait until age sixty-five.[65] He must begin to draw it down no later than the taxable year in which he attains age seventy and a half,[66] although he may continue to contribute after that age if he has not retired.[67] The age seventy and a half deadline is designed to prevent the use of the plan as a device to pass along the accumulated funds to his estate.

The tax imposed upon self-employed individuals (either owner-employees or junior partners) upon distribution of their plan benefits depends on the manner of payment. Distributions in the form of an annuity or installments are subject to tax at ordinary income tax rates. Lump-sum distributions are denied capital gain but are given the benefit of a five-year averaging device.[68] Amounts representing nondeductible contributions are returned tax free. Upon the death of an owner-employee, distribution must be made within five years after his death or applied to the purchase of an immediate annuity for his beneficiary payable over the beneficiary's life or life expectancy.[69] The estate and gift tax exclusions and the $5,000 exclusion for income tax purposes available to common-law employees are denied to all self-employed individuals.[70] Nor may a self-employed individual obtain any exemption from income tax if he retires for disability.[71]

Not only does an owner-employee suffer the denial of advantages available to common-law employees but he must tread warily around three pitfalls placed in his path by the act. First, he is subject to penalty if he makes a contribution in excess of the permitted maximums.[72] The excess

63. Int. Rev. Code of 1954, § 401(d)(4)(B).
64. Int. Rev. Code of 1954, § 72(m)(4).
65. Treas. Reg. § 1.401-12(m)(2)(i) (1963).
66. Treas. Reg. § 1.401-11(e)(2)(ii) (1963).
67. Treas. Reg. § 1.401-11(e)(7)(1963).
68. Int. Rev. Code of 1954, § 72(n).
69. Int. Rev. Code of 1954, § 401(d)(7).
70. Int. Rev. Code of 1954, §§ 101(b), 2039(c), 2517.
71. Int. Rev. Code of 1954, § 105.
72. Int. Rev. Code of 1954, § 401(e)(2)(A). As an exception to the excess contribution rule, the act permits an owner-employee to purchase annuity, endowment or life insurance policies from an insurance company at level premiums without fear of making an excess contribution. Under this exception, an owner-employee would be permitted to contribute each year toward the purchase price of his policy up to an amount equal to the amount he would have been allowed to contribute on the basis of his average earned income for years preceding issuance of the last such policy under the plan. Int. Rev. Code of 1954, § 401(e)(3); Treas. Reg. § 1.401-13(c) (1963).

must be returned to him within six months after receipt of notification by the Treasury Department that the contribution was excessive, or the plan is deemed to be disqualified with respect to him until the excess is returned.[73] Meanwhile he will be taxable on the net income of his share of the fund.[74] If the excess contribution is deemed by the Treasury Department to have been willfully made, there must be distributed to him his entire interest under all plans in which he has owner-employee status, the distribution is taxed at penalty rates, and no further contributions can be made under any plan on his behalf for five years.[75] In view of the stringent penalty, it would be a foolhardy individual who would risk contributions that might be deemed to be "willfully" made in excess of the permitted amounts. The possibility of innocent excess contributions is rather great, however, in view of the fluctuating incomes of owners of businesses and the fact that the contribution must be made before the close of the taxable year when the final profit-and-loss figure may still be indefinite.[76] The problem is complicated by the denial to owner-employees of the right to carry over to succeeding years contributions above and below the permitted amounts.[77]

Secondly, no distribution is permitted from the account of an owner-employee before age fifty-nine and a half except for death[78] or disability.[79] If a premature distribution is made, no further contributions for the owner-employee can be made for five years.[80] If the amount of the premature distribution is less than $2,500, the penalty tax is 110 per cent of the increase in tax resulting from inclusion of the entire amount in his gross income for the year of the distribution. If it is $2,500 or more, the penalty tax is 110 per cent of the increase in tax which would have resulted if the distribution had been received ratably over the current and four preceding years.[81] It is possible in this latter situation, in cases of low income over the preceding four years, that the formula will not actually penalize the owner-employee. Not only amounts actually distributed under the plan but amounts constructively received may bring down the penalty. The act provides that any assignment or pledge of an owner-employee's interest in a trust fund or any loan received under an insur-

73. Int. Rev. Code of 1954, § 401(e)(2)(C).

74. Int. Rev. Code of 1954, § 401(e)(2)(B).

75. Int. Rev. Code of 1954, § 401(e)(2)(E).

76. If the plan permits voluntary contributions and an owner-employee makes an innocent excess contribution, it can be allocated to his voluntary contribution if the plan expressly so permits and if he has not made his full voluntary contribution.

77. Int. Rev. Code of 1954, § 401(a)(9)(B).

78. Int. Rev. Code of 1954, § 401(d)(7); Treas. Regs. §§ 1.401-12(m)(1)(i), (3) (1963).

79. Int. Rev. Code of 1954, § 401(d)(4)(B).

80. Int. Rev. Code of 1954, § 401(d)(5)(C).

81. Int. Rev. Code of 1954, § 72(m)(5)(B).

ance contract shall be treated as an amount received by the owner-employee.[82]

The third pitfall is in the area of prohibited transactions. No qualified trust can engage in certain transactions[83] with the grantor or his family without certain safeguards. But H.R. 10 takes the approach that policing such transactions in the case of self-employed individuals who own more than fifty per cent of their business is not practical and therefore flatly forbids such transactions.[84] For example, no qualified trust established by an employer can lend money to the grantor without the receipt of adequate security and a reasonable rate of interest. But any trust which is part of a plan benefiting owner-employees who control (more than fifty per cent interest) their business cannot lend money to the owner-employee or his family or a corporation controlled by him. This is an absolute prohibition and no amount of security or interest will redeem it.

Let us take Messrs. Book and Case over the moment of decision and embark them on a plan. What should they contribute to the fund? Cash only? Or can shares of stock which have appreciated in value be turned over to the trust? Mr. Book, you will recall, has a sixty per cent interest in the firm. This makes him a controlling partner and so the partnership is absolutely prohibited from contributing property to the trust. The act states that "a partnership shall be treated as the employer of each partner,"[85] and the regulations provide that "the contribution of property, other than money, by the person who is the employer . . . to a qualified trust forming a part of a plan which covers . . . owner-employees who control . . . the trade or business . . . is a prohibited transaction between such trust and the employer-grantor of such trust. . . ."[86]

Contributions to the plan can be invested in any one of a number of ways, or a combination of such means may be utilized. Possible investments include common and preferred stock, annuity, endowment or life insurance contracts, face amount certificates, United States Treasury Bonds, qualified retirement bonds, shares of regulated investment companies, government or municipal bonds, mortgages, etc.

Since the plan of Book & Case provides benefits for one or more owner-employees, it must meet all the requirements of section 401(d). Section 401(d)(1) provides that a new trust forming part of a qualified retirement plan which benefits an owner-employee must have a bank as trustee unless the trust uses annuity, endowment or life insurance contracts ex-

82. Int. Rev. Code of 1954, § 72(m)(4).
83. Int. Rev. Code of 1954, § 503(c).
84. Int. Rev. Code of 1954, § 503(j).
85. Int. Rev. Code of 1954, § 401(c)(4).
86. Treas. Reg. § 1.401-12(k) (1963).

clusively to fund the benefits, in which case individual trustees may be used.[87]

Annuity contracts and face amount certificates, when made nontransferable, can be purchased directly from the issuing companies.[88] Face amount certificates are issued by Face Amount Certificate Companies registered under the Investment Company Act of 1940. They represent contracts by the issuer to pay a stated sum (the face amount) at a fixed maturity date in consideration of the payment of periodic installments or a lump sum.

Qualified retirement bonds may be purchased by a trust or may be purchased as the sole investment of a qualified bond purchase plan.[89] United States retirement plan bonds are entirely new and are issued under the Second Liberty Bond Act.[90] They may be purchased at any Federal Reserve Bank or branch, or directly from the Office of the Treasurer of the United States. The retirement bonds may be purchased only in the name of the individual employee. They are sold at par in denominations of $50, $100, $500 and $1,000, with interest at 3.75 per cent compounded semiannually. The annual limit is $5,000 in the name of any one person. Interest on the bond ceases five years after the death of the person in whose name it is registered. Partial redemption of bonds in the three highest denominations may be made. The bonds are nontransferable. They may be purchased as an investment by any qualified plan but they appear too restricted to be interesting. There is no tax incidence upon distribution of the bond.[91] Interest and principal are paid only upon redemption, which cannot occur before the owner reaches fifty-nine and a half years of age, except upon death or disability. The proceeds are not given the benefit of capital gain taxation, nor exclusion from estate tax, even to common-law employees.[92] A total distribution to common-law employees which includes some retirement bonds will, except for the bonds, not be denied capital gains treatment. The bonds, however, appear to offer one interesting possibility for self-employed individuals. A self-employed individual who cannot gauge too well when his tax bracket will be lower can convert some or all of his plan investments into retirement bonds and postpone tax incidence until he chooses to redeem the bonds.

87. Int. Rev. Code of 1954, § 401(d)(1). See Treas. Reg. § 1.401-12(c)(4) (1963), which provides that the employer must substitute a bank as trustee or custodian if it is notified by the District Director that such substitution is required because the individual trustees are not keeping proper records or making proper returns.

88. Treas. Reg. § 1.401-9 (1963).

89. Int. Rev. Code of 1954, § 405; Treas. Reg. § 1.405-1 (1963).

90. 40 Stat. 288 (1917) (codified in scattered sections of 31 U.S.C.).

91. Treas. Reg. § 1.405-3 (1963).

92. Treas. Reg. § 1.405-3(a)(4) (1963).

Another entirely new concept in H.R. 10 available to all qualified plans is the use of a custodial account in lieu of a trust.[93] The custodian must be a bank and the custodial account must be invested either solely in mutual funds or solely in annuity, endowment or life insurance contracts issued by an insurance company.[94] The shareholder of record of any stock must be the custodian or its nominee but beneficial ownership must be in the employee. Any insurance contracts must be held by the custodian until distribution.

Why a custodial account? The Senate Finance Committee Report states in part:

> Although a custodial account may be utilized by a retirement plan, whether or not it includes an owner-employee, it will be particularly beneficial to small owner-employee-type plans because of its lesser costs. Such lesser costs result from the fact that the bank would not be required to assume the duties and responsibilities of a trustee, but would serve only as a mere custodian of amounts contributed under retirement plans or of the policies deposited with it.[95]

However, the regulations require a custodial account to file the same returns and information required of a trustee[96] and some banks hâve indicated that accordingly there will not be much difference in fees. The regulations contain one further provision which may make the use of a custodial account unwise. They explicitly state that if a custodial account which has qualified under section 401 fails to qualify for any taxable year, the custodial account will not thereafter be treated as a separate legal person and the funds will be treated as made available to the employees for whom they are held.[97] The implication is clear that a custodial account, once disqualified, may not, unlike a trust, requalify.[98]

VI. Conclusion

It is clear that neither Messrs. Book and Case nor any other owner-employee should establish a qualified retirement plan under H.R. 10 without careful consideration of their total economic situation—projected as far into the future as possible. Owner-employees who are primarily interested in setting aside tax deductible moneys for their own retirement are most likely to be discouraged by the stringent restrictions of the act. On

93. Int. Rev. Code of 1954, § 401(f).

94. Shares of more than one mutual fund may be held in a single custodial account. Treas. Reg. § 1.401-8(b)(iii)(a) (1963).

95. S. Rep. No. 992, 87th Cong., 1st Sess. 18 (1961).

96. Treas. Reg. § 1.401-8(c) (1963).

97. Treas. Reg. § 1.401-8(d) (1963).

98. "An employer may designate several trusts (or custodial accounts) or a trust or trusts and an annuity plan or plans as constituting parts of a single plan. . . ." Treas. Reg. § 1.401-12(c)(5) (1963).

the other hand, owner-employees who would like to establish some kind of a retirement plan for their common-law employees in any event would be more likely to undertake such a plan now that they can themselves participate in it.

If the act is liberalized by future legislation, it should have far greater interest to self-employed people than it does in its present form. The opening gun has already been fired. On October 10, 1963, the first anniversary of the enactment into law of H.R. 10, Representative Keogh and Senator Smathers introduced into Congress identical bills[99] to amend the act to provide (1) that a self-employed individual may deduct his full contribution rather than half, and (2) that there would be no maximum to the contribution a self-employed individual could make for himself except in the case of an owner-employee who covers only himself.[100] Such an owner-employee would continue to be limited to a contribution of ten per cent of earned income or $2,500, whichever is less.

It is safe to predict that the legislative history of this amendment will prove as interesting and controversial as the legislative history of the present act and that further liberalizing amendments will be proposed as time goes on.

99. S. 229, H.R. 8771, 88th Cong., 1st Sess. (1963).

100. Of course, contributions would have to meet the test of nondiscrimination.